ADEPT
Socioeconomic Commentaries

January-April 2004

2003: we managed to hold out, but failed to break through
Anatol Gudim, 16 January 2004

The Government thinks "2003 will go down in history as a year of new achievements in socio-economic development of the Republic of Moldova" (V. Tarlev's speech in the Parliament, 26.12.2003). But Fitch Ratings, an international agency that the Government respects (London/New York), evaluated, nonetheless, 2003 as "another disappointing year for Moldova. The government has failed to accelerate structural reforms" (5.12.2003).

The truth apparently is somewhere in between. One could assess the work of the Government, Ministry of Finance and National Bank as successful based on the fact that they managed to maintain macroeconomic stability, there were positive changes in industry, constructions and services, incomes of the population increased, but the Government's activity along the reformation path has been mostly based on the "one step forward - two steps back" principle, which was the cause IMF and World Bank were so evidently disappointed saying that *Moldova's liberal-market economic course is being transformed into state dirigisme*.

PR-economy

Any government has to produce optimism. And ours does the same. Results of the year, according to official estimates, are very optimistic: GDP grew by 6.8%, industry - 17.0%, domestic investments - 23.0%, export - 25.1%. State budget incomes increased by 36.2% and incomes of the population - 19%, including average monthly wage in the national economy - by 31% and pensions - by 28%. Social sphere received 53.7% of the total expenditures of the consolidated budget.

These indicators of "achievements" were published many times to confirm that actions to revive the economy were correct. It would be proper, though, at the same time to mention the risk factors as well, that intensified, rather than subside in 2003. Among them are:

- *Quality, structure of the GDP growth*. Share of real sector is rather small within the 2003 GDP growth (industry, for instance, accounted for only 11.5%). Its largest part is being formed in services, import operations, by means of banking credits, etc. GDP growth given such its structure is not equivalent increase of real resources at all. Especially since the budget has nothing to do with formation and distribution of GDP. Hence the population does not really feel this growth;
- *Unsatisfactory state of business environment*, which shows through insufficient volume and structure of export (it is still less than the 1997 level), uncertainty of foreign investors' disposition, freezing of privatization and preservation of a vast shadow economy sector;
- *Critical state of the country's balance of payment* due to almost double (!) exceeding of import over export, while after relations with IMF and World Bank had cooled off, possibilities of receipt of currency through external loans and investments have sharply dropped. Of a little help is replenishment of the

country with money transfers of our citizens working abroad - circa 500 mil USD in 2003;

- *Inflation leap* up to 15.7% in 2003 (4.4% in 2002) and 20.0% increase in prices for foodstuff. Approximate 1/3 increase of wages and pensions also left its traces, even though wage arrears reached 175,7 mil MDL (13,3 mil USD). Danger of a critical gap between the need to expand monetary aggregates and capacities of the inflation-free emission;
- *Further increase of external* (1,4 bil USD) and internal (2,9 bil MDL) state debt;
- *Unreformed state machinery*, which is the cause many "2003 initiatives" either were not realized, or yielded small or negative results. Among them are: advancement along the way of European integration, implementation of the strategy of economic growth and poverty reduction, development of a competitive environment and small and medium business support, activization of export and foreign investments attraction, administrative-territorial reform, fight against economic crimes and corruption, rapprochement with Transnistria.

All these circumstances are so evident that the President V. Voronin at the last in 2003 session of the Government (24.12.2003) pointed out that "programme goals of the Government are fully not realized and instruments stipulated for by the government action programme "Revival of economy - revival of the country" are not used to the right degree".

Look from outside

Moldova from the outside is perceived as a country, where due to the inertia of the 90's, but through other methods, "survival policy" is still realized and that does fail to activate factors of sustainable economic growth.

The Government admits the same by implication through its forecast for 2004-2006 of a GDP growth reduction to 5.0% as compared to 6-8% GDP growth achieved during the last two years, while international organizations and rating agencies' forecasts even lower - only 3.5-4.0%. Such rates cannot solve anything indeed. After all our GDP per capita (460-500 USD) today is the level of such exotic African countries as Senegal, Cameroon or Ghana. And in this situation Republic of Moldova, the poorest European country really needs a breakthrough in economic policy, consent between the government and the society on composition, rates and order of transformation of the country's economy.

We aspire to enter Europe. So here is a look from that direction at our starting position: "due to insufficient work of administrative machinery and lack of an efficient democratic control over the former Moldova's economy encounters high level of corruption, informal sector making up almost 80%, which is why incomes from taxes are being lost; there is no control over the eastern border of the country and its social system is insufficient" (Resolution of the European Parliament on Moldova, 18.12.2003).

What's next?

Unfortunately, 2004 is another pre-election year and, of course, there will be a lot of PR-economy and promises. One could, nonetheless, insist that the country's economy had already adapted to market conditions and therefore growth inertia has already emerged, and given all risk factors no one should expect any force majeure events (as a default) during the new year. There are encouraging signs that, economic policy will finally become intelligent and, according to Marian Lupu, Minister of Economy, we have ahead a "year of active actions" combined into five "baskets": macroeconomic conditions for implementation of structural reforms; raising of competitive economy's potential; social policy; elimination of infrastructural restrictions; state management system reform.

The latter is especially important. During the nearest years it will be modernization of state bodies under the European standards, raising of the society's confidence in the state that will be of decisive importance, rather than so-called market reforms.

Inflation in the Republic of Moldova: causes and effects
Iurie Gotisan, 9 February 2004

National Bank of the Republic of Moldova is responsible for the monetary and foreign exchange policy. Under its bylaws NBM's main goal is to "realise and maintain the stability of the national currency that ultimately provides reduction of the inflation rate, ensures the general level of prices and of the exchange rate of MDL". Each year Government sets an inflation rate after prior talks with IMF. Last month, NBM made public its monetary, credit and foreign exchange policy for 2004. Monetary policy was developed based on the following indicators, real GDP growth by 5%, inflation rate of 8-10%, an average estimated exchange rate of 15.2 MDL for 1 USD. Monetary bodies' policy was always quite forthcoming - reducing inflation at any price.

Inflation reduction from 23.8% in 1995 to 4.4% in 2002, though many analysts still doubt those figures, was in fact a big step towards the stability of the Moldovan Lei. However, the 15.7% inflation rate registered last year has handily outstripped NBM's forecasts. Noteworthy, periodical drops in the inflation rate were preceded by some hard fluctuations, even some sharp ones, as was the case in 1998-1999, when inflation rate teetered between 18.3% and 43.3%. This sharp drop was largely due to Russian financial crisis. Republic of Moldova was hit by that crisis as at the time Russia accounted for more than 70% of its foreign trade. Still many economy-watchers express lingering concerns with regard to National Bank's forecasts on the inflation rate, for them even 8-10% is a quite optimistic forecast.

Here are some of my thoughts on the high inflation rate as well as some ideas on how to keep it under 10% in 2004. Monetization, common to all transition countries at least during their first years of transformation, was the system's response to the huge "structural strain" a result of the inefficiency of many companies when it came to the new liberalised prices. On the other hand, such factors as arrears and debts, price formation by companies, and a certain exchange rate regime have brought new structural dimensions to the inflation and made them chronic. In turn chronicity has boosted even further the inflationist expectations. The latter are also related to the low credibility of the stabilisation measures undertaken throughout the years.

Still, throughout 1995-2003 National Bank undertook some major *quasi-fiscal operations* (subsidisation of certain types of economic activity), either through foreign exchange policy, or credits under preferential terms. In 2002 the lowest inflation rate, i.e. 4.4%, in the 11 years of transition was registered, that achievement was largely due to administrative control over major prices (including appreciation of the official exchange rate, energy price, etc) and sharp monetization of economy. Monetisation (which stands for surging monetary assets in GDP) was largely due to positive interests for the first time ever, which in its turn have made long-term deposits more attractive. Monetisation also explains how was it possible that huge currency issuing (M0) and implicitly soaring liquidity (M2) in economy brought among others by subventions (other than from state budget) to agriculture and other sectors have not ensued in immediate surge of inflation.

As for the monetary source of inflation, it is worth mentioning that inflation kept high regardless of GDP, when being high and when being low. In other words, the economic cycle (of business) has had more of a saying in shaping the inflation, at least in the last 11 years of transition. Throughout that time, National Bank issuing, i.e. currency and bank deposits (either as a countermeasure to surging net foreign assets, or additional net credit granted to commercial banks) was quite high. Those years were characterised by monetary bodies practising quasi-fiscal operations, so as to monetize deficits in economy. Quasi-fiscal operations were the primary cause of soaring issuing, which made the control over liquidity a more challenging task. They indicate a still insufficient level of restructuring in the Moldovan economy, as well as the fact that National Bank took over some funds care, that should have gone to the public budget. In the recent years quasi-fiscal operations resumed to National Bank buying state securities issued to aid struggling banks.

While state securities operations are targeted at shaping monetary market (such as the level of interest rates), in Moldova such operations were employed to indirectly finance budget deficit. To put liquidity under control, National Bank had to issue certificates of deposit and raise the level of obligatory reserves of the commercial banks held at the National Bank. To preserve the stability of the national currency and reduce inflation, last year National Bank Administration Council raised the obligatory reserves from 10% to 12%. The move deprived monetary market of an estimated 400 million MDL, which as a result eased the speculative pressure on USD. However, the move felt short of those expectations. Commercial Banks did not redirect their foreign currency placements, but rather had to decrease the amount of credits offered to the real economy sector. Reduction of the stock of money, and implicitly of the credit, may lead to a considerable increase in interests, that is to damage the bank portfolio due to the impact of the credit cost on the real economy.

Moreover, shortage of Lei determined some commercial banks to resort either to interbank credits or to the sale of securities, thus increasing the interest rates on those financial instruments in the future. At the same time, high interest rates would eventually affect budget equilibrium and businesses' crediting, as well as overall economic stability. Confronted with high interest rates, economy would end with short-term capital inflows, that might eventually lead to a sharp appreciation of Moldovan Lei and as a result drop in export revenues and growing commercial deficit.
Armed with formulae and tables of data economists would probably argue that soaring interest rates would attract foreign capital, that would in turn increase the volume of foreign net assets and bring the monetary market back to normal. Unfortunately, Moldovan realities have proved totally opposite, especially given the state's deficient position when it comes to investments. The capital likely to be attracted by the skyrocketed interest rates would be a speculative one, ready to flee the country upon the first signs of danger. That is exactly why IMF's traditional set of economic policy recommendations are built from the perspective of descending evolution of the interest rates, rather than ascending one.

It is all-too-clear that measures undertaken by the National Bank have more of analgesic than therapeutic effect. A similar thing happened in 1998 when in two weeks NBM raised the obligatory reserves from 8 to 15%, and than gradually decreased it throughout 2000-2001. NBM monetary policy for 2004 provides for a gradual decrease of obligatory reserves up to 8%, however it seems it would be impossible to achieve. It is not clear for how long NBM would be able to support the financial pyramid that is more and more inclined to collapse. Still, we would like to think that what we experienced in 1998 was the worst thing we had to go through. That is why, Government together with National Bank should find the most appropriate measures for recovery. And this because the former is largely responsible for the inflationist expectations and depreciation of the national currency, as it increased budgetary expenditures while failing to secure funds to cover for them, and missed foreign crediting.

Structural causes of inflation are related to insufficient restructuring of the economy. Slow reallocation of funds and low level of foreign direct investments (less than 3% of the GDP, that are in a way creating workplaces) have kept a strong pressure on the public finances and NBN when it was not free of quasi-fiscal operations. Noteworthy, those operations were undertaken also due to the system risk, that is the need to prevent the collapse of the entire banking system, in this respect a close link could be found between inflation and arrears. In my previous writings I sought to prove that arrears reflect economy's incapacity to quickly adjust to various shocks and that they may be viewed as temporary quasi-inside money, in other words "antibody" to shocks. High areas (35-40% of the GDP in the recent years) point to the insufficiently restructured economy (such as the appetite of many companies for state subventions in order to survive) on the one hand, and on the other the temptation of many businesses, even profitable ones, to evade taxes. Sharp surge in arrears coupled with the impossibility of current payments would block the economic system and result in a wide-scale crisis.

As is the case of many economies in transition, an ongoing competition between the state enterprises and private ones in failing to pay for the debts and perpetration of actions towards inflation. To put it differently, fighting inflation should be accompanied by imposing tough budgetary constraints, so that companies (especially the state-run ones) would pay taxes to the state budget. From this perspective, last year Government ordinance on freezing the debts worth 500 million Lei was doomed right from the beginning, as it did not address the major causes that led to huge arrears in the first place. It comes as no surprise than, that the names of the companies who benefited of the said ordinance were never disclosed, nor were the details of operation; however one may easily guess which particular companies enjoyed Government's mercy. Indeed, the said ordinance proved quite handy to moguls in Government or Parliament who stay behind those particular companies and who are jostling for influence. When the law turns into business it does no longer serve its purpose, whereas in business money factor undermine the decision-making.

Without a better financial discipline, it would be difficult to reduce sharply inflation and it would also create some problems to the banking system with many companies facing an increased financial blocking. Freezing debts involves a number of risks. And these are threefold. Firstly, the move induces a harmful fiscal treatment in economy. Huge debtors, state owned companies, might be led to believe that sooner or later they would benefit again of such fiscal charity. Thus, they would be encouraged not to pay the debt in line with a quite simple reasoning: the state forgave me once it will forgive me once again. However, small business would never indulge in such a reasoning. They know far-too-well that fiscal bodies are not are as forgiving when it comes to small-to-middling business, whereas fiscal control bodies are merciless when it comes to them paying arrears to state budget. And here we come to the second risk: the move runs counter to the very principle of fair competition. It comes down to discrimination, i.e. there are those who enjoy a preferential treatment and those who don't.

And finally, unless freezing of debts is backed up by payment of current debts, in a year or so Moldovan economy would be on the verge of a crisis. Financial blockage would be so huge that the state budget as well as private economy would run the risk of being suffocated. These huge debts are nothing but a ticking bomb ready to explode anytime, thus triggering a major financial collapse. The explosion wave would reach us regardless of whether we are shielded by a relatively balanced budget or not. Under the current circumstances, it would be smart to weight all the implications of such economic measures, so as not to run for some bubble benefits in the future, instead of some solid gains today.

It we are to look at maintaining a stable general price index, the raft of measures and mechanisms employed firstly by the NBM and later on by Governments that succeeded each other, were aimed primarily at keeping inflation under control. Inflation rate throughout 2000-2002 was the lowest ever. In 2000 it was estimated at 18.4%, in 2001 - 6.3%, whereas in 2002 - only 4.4% (!), the lowest in the former soviet area. Also, it is quite interesting that the monetary stock in circulation grew in 2002 by 36%(!) reaching 6,511 thousand Lei, as compared to only 4,787 thousand Lei in 2001, whereas GDP grew by only 6.3%. And here's a paradox: how was it possible to have such a low inflation rate, when the economy grew by nearly 6%, while the monetary stock grew by 30% (!). Monetary stock growth exceeded even the prices' growth, which rose on average by 5.2% per month on consumer goods, whereas the monetary stock rose by 7.8% per month.

In this respect, the limitations of monetary policy in influencing the real sector of economy were quite obvious. NBM's consistent restrictive policy has only partially achieved its goals, it managed to head off hyperinflation that was imminent at that time. However, we may not help wondering: how was it possible to reduce inflation to a one digit figure (below 10%) in 2001 - 2002, at the time there were no signs of wide scale restructuring. One answer is related to the durability of the low inflation rate, which is still questionable in many situations. The second explanation stems from the inflation impact on the amount of debt in real terms. That is exactly what determined the suspension of salary payments throughout 1996-1998. At the same time, arrears to the salary payments to state employees reached in 2003 almost 200 million Lei, whereas the need to pay suppliers of paramount goods, such as Russia delivering natural gas, made inflation exercise a even harder pressure on economy. Thirdly, such factors as large scale barter in domestic trade and high unemployment rate (around 20%) require an urgent wide-scale restructuring, and return to higher inflation rates. In Bulgaria there is a Monetary Council (establishing fixed rate of the national currency to a reserve currency, whereas the monetary policy is null) the dynamics of monetary offers rests only on the inflows and outflows of Central Bank's international reserves (the great majority of countries that undergone financial crisis in the last decade - Argentina, Estonia, Lithuania, Mexico, Indonesia, had a fixed exchange rate that triggered the financial crisis in the first place). In Albania also, low inflation was brought by financial crisis that had a disastrous effect on the people's savings and generated huge public debts (which is quite relevant for Moldova as well).

This once again proves that liberalisation and stabilisation of the macroeconomic factor does not in itself produce institutional and macroeconomic basics necessary to boost economy. Moreover, by breaching Central Bank's independence, the Government once again used it for its own good (making it cover the state financial holes from its foreign currency reserves or cover budget deficit), thus tarnishing its credibility. Another example in this respect is the artificial maintenance of low Lei/ USD rate, albeit it points, as does the trade balance deficit that reached 600 million USD in 2003, to the fact that Moldovan economy is feeble. Artificial strengthening of national currency and thwarting liberalisation of exchange rate have considerably affected economy by making imports cheaper and exports costly.

For instance, on average in 2003 the real exchange rate of MDL against Russian Rubble (prices in Moldova as compared to those in Russia) was almost 23% higher than prior to the financial crisis. However, if compared to economic conditions in Belarus and Ukraine, the prices rose by more than 17%. If we are to refer to 1998, than the gap between the prices is even wider: compared to Russian economic environment Moldovan prices rose by 30%, compared to Belarus by 40%. Skyrocketed prices were the result of discrepancies in the real exchange rate and inflation. For instance, average level of prices in 1998 rose by 40% as compared to 1997, whereas exchange rate of USD against MDL rose by only 3%. It is all-too-clear that between 1998-1999 the exchange rate rose at a faster pace than prices, a similar situation was registered in 2000-2001. As a result, in 2001 average price level rose by 43% as compared to 1999, whereas the exchange rate by only 23%.

It may well happen that in 2004 inflation rate would rose at its fastest speed. And this due to increased prices on imported energy, as well as on energy delivered to industry and housing. Another factor that might perpetrate inflation is commercial banks providing credits under preferential terms to businesses, which eventually prove to be inefficient. Albeit commercial banks' non-operational credit portfolio has reduced, banking system is still weak and divided. Chaotic turbulence in financial system only fostered inflationist expectations among the population. Although Republic of Moldova headed off default and its foreign currency reserves rose by 310 million USD, according to sources in NBM, country rating remains low, which means that the cost of loans on the international capital market is still quite high.

Consequently, anti-inflation program should not simply resume to NBM reducing issuing (M0). It should also include measures to be undertaken in the monetary and foreign currency fields, public finances, imposing financial discipline, revenue policy, overseeing financial and banking system, anti-monopoly legislation and competition policy.

Discord among authorities and domestic producers
Iurie Gotisan, 25 February 2004

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For domestic producers "Produced in Moldova" exhibition opened on February 10 was a good opportunity to complain about deficient laws, high taxes, tight competition with foreign importers, and not less important bureaucracy; rather than show off their products, the great majority of which have been presented earlier anyway. New products were indeed presented, however all of them are nothing but a shallow recollection of a once prosperous industry. The industry was ruined not by the collapse of the soviet empire, as Communists like to think, but rather by the incapacity of Moldovan reformers to seize the moment and set the country on the course of reforms, as well as by the fact that Moldovan political elite, instead of building long-lasting partnerships with business, set itself in a policeman position.

Albeit Commerce and Industry Chamber and National Association of Producers had hoped to show the potential of Moldovan industry, in the end the only thing this event did show was that national producers and Government were still on different sides of the battlefield and that they still had very few in common.

It's easy to criticise the state for its incoherent policies, however there is plenty room for criticising the businessmen as well. For a start, they want the state to protect them from unwanted international competition, by taking protectionist measures, which is quite a task especially since Moldova joined WTO. On the other hand, many industrialists still refuse to acknowledge their obligation to reward the protectionism the state had granted them, by paying taxes. What's also strange is that great many businessmen ranted about the high fines levied for non-compliance with the law, rather than about high taxes. This reasoning is inherent to the soviet-time style of making money, when the businessmen contribute towards social welfare by building overly sumptuous villas.

In its turn, Government seeks to keep economy under control. To cite just the pressure wielded on the foreign investors, or the Communist Party electoral program, reading "the end goal of the Communist Party is for the state to take over the means of production and establish a socialist economic system". Cosmetic measures undertaken by the Government to show business community that "country leadership is on their side" cannot possibly handle the toughest challenge Moldovan economy is facing - shadow economy. According to a recent UNDP report, shadow economy in Moldova accounts for 50% of GDP. Businessmen and Government alike agree that it's their shared responsibility. The former, used to the state merciless, does not dare to go in the open. The state, wrongly assuming that high taxes mean higher revenues, refuses to cut taxes, which for more than a decade now are the highest among the transition countries.

For instance Hungary and Poland due to join EU soon, lure investors by low income taxes of up to 20%. Having said that, what "carrots" does Moldova have to lure foreign capital? The recent reformatory law package passed by the Slovakian Parliament reduced the income tax to 19%. A single taxation quota is used in Estonia, Latvia, Lithuania, Russia (13% income tax and no social payments), and Ukraine as well, whereas Baltic countries make their "fiscal offer" even more attractive by further cutting the taxation basis. Those regional tendencies to reduce the fiscal burden would most likely affect Republic of Moldova in terms of attractiveness to investments, unless the country comes with a competitive advantage.

Taxes in the region are well bellow those in Moldova. Therefore, Government would have to take a raft of measures to preserve its economic competitiveness. For some political reasons, Government's fiscal strategy overlooked the "investment magnet" that works so well in Central and Eastern Europe. Too much of a fiscal burden is similar to a too high interest rate, when it affects the balance sheet of indebted companies. A slight drop in the corporate income tax from 25% to 22%, as provided for in the 2004 budget, is not enough to decrease the number of businesses in "shadow". Although apparently they understand this, authorities refrain from taking the path of fiscal reform for fear to loose the meagre revenues they currently collect and that are necessary to fund the populist social policies promised by the ruling party during the electoral campaign.

Going back to the event that determined me to put down some thoughts about the state of Moldovan business, I should acknowledge that the problems raised by the business community are already know, i.e. obligatory inspection before expedition (in the eyes of many stymieing Moldovan business), high energy costs included in the final product price, pressure wielded by the bureaucrats and excessive state control. Some of the aforesaid problems have already become inherent, especially when it comes to high energy cost. The latter is due not only to obsolete equipment and distribution networks, but also to worn out production lines and technology - common feature of the great majority of businesses present at the exhibition. This has lead to a paradox - the share of energy consumed by Moldovan industry in the growth industrial product is one of the highest in Europe, whereas the share of energy consumed by the citizens is the lowest in Europe.

Exhibition was held under the auspices of Prime Minister Tarlev, who also heads the National Producers' Association. Probably Tarlev's unspoken message at the reunion was "I used to be a businessmen myself, so I do know business problems far too well". What's striking is that although Tarlev comes from business community, his former fellow colleagues agree that the tensions between state and producers have never been higher. Business' response to the governmental interventions in economy was quick: in January the revenues to state budget dropped sharply as compared to last year.

Although, high taxes were in the spotlight throughout the entire exhibition, in a recent interview to "Economic Overview" the Chief of State Fiscal Inspection stated that the Fiscal Code in force at the moment was the best possible option. Therefore, my dear businessmen mind your own business, as the fiscal revolution has been adjourned!

Liberalisation of capital flows
Sorin Hadarca, 16 March 2004

e-journal, II year, no. 26, 16 March 2004

Liberalisation of capital flows has been right from the beginning a rather controversial issue in the Moldovan foreign exchange policy. Restrictions on capital flow imposed on Moldovan citizens stem from the efforts undertaken by authorities at the dawns of independence in order to keep a stable exchange rate of the national currency. At that time, still ravaged by hyperinflation that had outburst before the introduction of the Moldovan Lei and conversion of Moldovan Rubbles, coupons and, finally, Lei into US Dollars or goods, putting obstacles to the currency outflow was deemed quite legitimate.

Later on, in the aftermath of the regional crisis that culminated in Moldova with the floating of the Leu, liberalisation of capital flows became a rather thorny issue and has remained ever since a taboo. Noteworthy, Moldova is not alone in this experience; almost all the former soviet countries do have a rather restrictive foreign exchange policy. Teetering between Turkmenistan and Belarus at one end and Armenia and Baltic States on the other, Moldova is somewhere in the middle with a relatively opened foreign exchange regime. Indeed, existing restrictions are somewhat asymmetric in that they envisage mainly the citizens of the Republic of Moldova, whereas non-residents are free to pull away their capital.

This "asymmetry" of right was aimed at establishing a favourable climate for the foreign investments. Indeed, non-residents may freely make direct and portfolio investments and they may also credit domestic businesses. Similarly, non-residents are guaranteed the right to unconditionally repatriate investments at their own will. The only thing non-residents might complain about is the obligation to form the registered capital in Moldovan Lei (that has been scaring away foreign banks for many years) and limitations on their participation in the T-bills auctions at less than one third of the face value. The latter is rather formal given that since 1998 the share of non-residents holders of T-bills has been almost null. Binding registration of any foreign obligations is frequently cited as a restriction on capital inflow, however one should admit that it is more of statistics and refers explicitly to the debtor resident's obligation to register the credit under the established terms rather than that of the non-resident.

Under a closer scrutiny one might find that such type of restriction on foreign currency flow has proven to be inefficient. The countries that in the past had (or even now have) closed foreign exchange regime have pursued such economic policies for some reasons.

One of those reasons was to limit the free circulation of capital across the border in order to protect foreign currency and financial market from external currency fluctuations. In this respect, a number of countries (such as Chile) have limited one way or another, the short-term portfolio and credit investments. For instance, Chile used to require a deposit equal to one quarter of the investment to be made in the central bank for a one-year period. The reasoning behind those measures was that short-term investments are the first to flee the country at the slightest sign of danger, thereby severely affecting foreign exchange and financial markets. Other countries have limited foreign capital access to certain industries of strategic importance for the country. Venezuela and Turkey are eloquent illustrations in this respect.

Moldova is totally different from the two groups. The incipient financial market is in itself a shield against any foreign currency shocks. Similarly, any investment, regardless of the industry it goes to, is more than welcomed. Under these circumstances, foreign currency restrictions are targeted at those citizens of Moldova able to invest their savings solely within the Republic. Natural entities are entitled to open deposits in the commercial banks of Moldova both in US Dollars and Lei, whereas businesses are entitled to make investments only in Moldovan Lei. They have access to foreign exchange market only in as far as satisfying their demand for foreign currency so as to cover for import transactions, whereas the sale of foreign currency is absolutely free. Another restriction somehow related to capital account is the obligation to repatriate revenues earned from exports. To conclude, Moldova is the one and only destination for domestic capital.

This state of affairs has a number of drawbacks, in particular:

- Asymmetric liberalisation of the capital account does not shield foreign exchange and financial market from the foreign shocks;
- Forbidding access to foreign financial markets infringes on the domestic investor's freedom and reduces the value accrual capacity at the local level;
- Impossibility to open deposits abroad decreases the competition between domestic commercial banks and foreign ones, that in turn brings about wide-scale coalitions that set fat commissions;
- Distortion of the exchange rate via asymmetric access of participants to foreign exchange market;
- Restrictions boost black market of services of the kind as well as ingenuity in evading the law, thereby playing against the honest ones;
- Bureaucratic burden stemmed from the need to keep costly system of tracing transactions with non-residents, which decreases banks' overall efficiency and incurs additional costs to businesses;
- Finally, existing restrictions run against the EU spirit, which Moldova seeks to join and therefore are to be abolished anyway sooner or later.

It is all-too-clear that the current system bears a number of strong points as well, among others the system is operational, to say the least, it is familiar to businessmen and banking clerks alike. It also allows keeping an updated record of clients and helps fight money laundering. However, the aforesaid benefits miss the target as initially the restrictions were established for totally different reasons.

We should give the credit to the National Bank, which has recently developed a number of modifications to the legal provisions with an eye towards, if not total liberalisation of the market, then at least modernisation of existing mechanism. It refrains from radical changes of the legal framework, though sets the course on liberalisation. In my opinion, liberalisation should be done at a large scale. Interconnectedness of economic processes impairs the efficiency of a partial liberalisation and imposes new requirements. Moreover, partial liberalisation would allow using the opened channels to avoid still existing restrictions. Total liberalisation would enable us to avoid those handicaps. Noteworthy, the effects of wide-scale liberalisation would not affect us immediately as normally economic transactions are tied to rigid terms of maturity.

The current situation on the foreign exchange market provides a unique opportunity to implement such a policy. Sooner or later, upon EU accession, liberalisation of capital flows would be a must for Moldova anyway. Therefore, we might as well consider undertaking such a step while we still can, without being under pressure which is the common case here. Therefore Moldova might want to seize this opportunity and be back on track in the global capital marketplace, which it has gone astray for so long.

Crisis aftermath
Iurie Gotisan, 30 March 2004

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e-journal, II year, no. 27, 30 March 2004

The recent developments in the drought crisis make a price hike on bread quite inevitable. Definitely the skyrocketed prices would be presented as a phenomena affecting each one of us. Moreover, when it comes to food any slight increase in prices affects directly vulnerable strata especially the elderly. According to official statistics food accounts for 70% of the expenditures in poor households. And bread is indeed one of the basic food products and is in demand regardless of the price fluctuations. Therefore, Chisinau residents would have to cut-off other expenditures, including those on communal services, so as to keep afloat. Having said that, it is clear that any slight increase in prices on bread would have a disastrous impact on the population.

Even back in October it was quite clear that prices would be propelled further upwards, and this because of surging production costs. If there are to be any bread manufacturers at all, then they should be entitled to a profit margin, at least a minimal one. Moreover, given the rising cost of wheat and the gaping lack of grain on the internal market one may well expect that the previous price hike would not be the last one. Though, governmental officials are well aware of that. Therefore, one may rightly wonder should people be warned beforehand about any price hike?

On the one hand, if announced beforehand, the market and stores would be a mess. Government should have announced early during the harvesting period that given the circumstances a price hike was inevitable, for the citizens to have time to find alternative sources. Franzeluta's increase of prices back in November 2003 beset a social upheaval. Prices surged by 30-60% depending on breadstuff. Though, the bread whose price Franzeluta claimed kept steady was nowhere to be found.

Recent tensions between bread manufacturers and governmental structures, which certainly are politically motivated, stand out as testimony to the fact that the famous promise to keep bread prices down made by Communists in elections, was compromised by economic realities. It is known for a fact that governmental officials pledged to keep the prices down or at least steady for another couple of months, regardless of market outlook. It is also true that the state did try to keep prices under control, move that besides running counter to the very principles of market economy where prices are shaped by offer and demand. It is all-too-clear now that market forces impinge on the political will of the ruling party. Currently grain reserve of the Republic of Moldova reached 30 thousand tones, amount enough to take it until April 15. Moldova's wheat harvest in 2003 was ten times less than in 2002 amounting to only 102 tones. Amidst those negative developments in the agricultural sector, it's hard to predict as to how Moldova would cope without foreign aid.

On top of that, sharp price hike on bread sets a favourable economic and psychological climate for a hike in prices on other food products. As if to underline this point a big dairy manufacturer has already announced it would revise its prices.

Unless bread prices drop to the previous average, one might well expect other prices to be propelled further upwards in the next couple of months, so as to balance the level of relative prices on food products.

Besides the likelihood of other prices being adjusted to surged breadstuffs price, there is also the risk of triggering an inflationary spiral. Trade unions would demand labour contracts to be renegotiated, whereas social rallies and strikes would be inevitable. To diminish the domestic debt Government might have to give up timely payment of foreign debt so as to be able to raise pensions and nominal subsidies without even having funds to cover for them. And such a move would definitely upsurge foreign debt.

"Investment Boom": joining together banking capital and companies in real sector
Iurie Gotisan, 14 April 2004

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e-journal, II year, no. 28, 14 April 2004

Amidst recurring debates on economic issues in Moldova, a recently passed law has been unduly overlooked, namely the Law on Financial-Industrial Groups. At a first glance it seems to be a worthy piece of legislation once it seeks to boost investments in economy and establish competitive manufacturing branches. To this end the law intends to unite banking capital to companies in the real economy sector.

Moreover, two weeks ago Parliament passed the Law on Investments in Entrepreneurship in the second reading. Lawmakers claim the law is set to pursue similar goals to the above-mentioned law, i.e. improve Moldovan investment climate. In particular, the law is said to guarantee that no investments would be expropriated or nationalised. As the law hasn't been published yet, one may judge based on official statements only. Therefore we would consider in greater detail the Law on Financial-Industrial Groups below.

What were the reasons behind adopting the law? At the first glance everything seems plainly clear. Domestic manufacturers, driven away from banking sector by huge interest rates on credits, may not supply the total investments needed for the economy. For the sake of comparison, total investments in national economy reached 75 million last year, i.e. three times less that the estimated annual amount of drugs smuggled through Republic of Moldova. One of the Communists in Parliament argued that the new law was needed precisely to improve investment climate. However, it is our belief that the law raises more problems than the answers it gives. Therefore, one may easily claim it is more politically targeted than economically.

There is already one financial-industrial group in Moldova registered under the 1995 Law on Enterprises and Entrepreneurship. Once the current legal framework allows for the operation of financial-banking groups, then it is not clear why a new law was needed in the first place? It would have been much simpler to operate amendments to the Law on Enterprises and Entrepreneurship and Law on Financial Institutions.

What is striking is the procedure of registering financial-industrial groups. Under Article 11, to get registered groups should submit along with other documents the so-called organisational project, i.e. a note explaining the technical and economic reasons for establishing the group. The draft shall be submitted for the expertise of state authorities. In their turn they might refuse registration, among others because technical and economic reasons were not grounded enough. On the other hand, article 13 of the law stipulates that registration may not be refused on the grounds it is deemed inopportune.

Even more interesting is the fact that one of the main criteria in deciding whether to register or not would be the "degree of project orientation towards fostering efficiency in production based on re-establishing unification ties". In this respect, is it not the case of re-establishing the unification ties within the former soviet area? Buzz goes that the law was developed for one single enterprise headed by one of the former

Prime-Ministers, which exports agricultural products to Belarus and imports agricultural machinery to Moldova.

Another interesting provision stipulates that profit and non-profit organisations (legal entities), except for public associations and religious organisations may found financial-industrial groups. Then, one may well read the provision as allowing let's say political parties not listed under exceptions, to be members of the financial-industrial groups!

However, the most striking fact is that the state would undertake measures to support financial-industrial groups active in the priority fields of national economy. Still, a quite simple question inherent to the very nature of the would-be financial-industrial groups arises. To begin with, those groups in fact represent a combination of long-term bank credits with greater technological possibilities of the group manufacturers, that is, such a structure would be endowed with a financial power anyone would covet. Then what's the state support for, if not the state's intention to take control of the most important fields of economy? An evidence to this effect is yet another provision of the law. Under Article 26, any debt a member of the group owes to the state may be converted into shares or bonds issued by the group and transferred into the state property.

Interestingly enough, the law was lobbied by Communists in the previous legislature. Supposedly, communists should have feared any merger of the banking and production capital, as Marx and Lenin put it - which brings the victory of the retrograde capitalist forces. However, Communist deputies, who were the pioneers of the law, claimed the most useful means of making use of the banking capital in the real economy sector was for the banks to have a share in the registered capital of the corporations.

Conversely, one of the National Bank's regulations limits commercial banks possibilities to have a share in the capital of other corporations as it might jeopardise bank's liquidity. This aspect is dealt with in the aforesaid law, which enables National Bank to grant privileges to certain banks, in particular by reducing the obligatory reserves quota. This in turn, would distort competition on the banking market. Further, it may well happen that new amendments to the banking regulations would not be possible to operate unless National Bank administration is changed.

It is our belief that the Law on Financial-Industrial Groups coupled with the denigration campaign launched by the incumbent ruling against public institutions and private businesses stand out as evidences that a campaign of redistributing key positions in financial and banking systems overseeing bodies is due to set out. Most likely persons loyal to Communists would secure those seats.

If this is to happen, Moldovan financial system would once get stuck in funding social and economic measures. Therefore there is only one way of meeting electorates' expectations, i.e. additional money issuing and crediting the state under preferential terms. The experience of other countries has shown far-too-well the consequences in terms of inflation of political tinkering in the financial and banking system. Is it then a new price hike that Moldovan people really want?

Moldovan's agriculture structural deficiencies
20 April 2004

What is striking is that in such agricultural country as Moldova is, agriculture lags far behind its neighbours both in terms of development and technical equipment. Overall economic efficiency of Moldovan agriculture is very low, out of the total agricultural enterprises only 35% are lucrative. While agricultural and food products account for more than 60% of Moldovan exports, only 12.8% of the total investments since 2002 went to agriculture. An average Moldovan farmer feeds 1.5 persons, whereas an European one 15. Therefore, on average labour productivity in Moldova is 15(!) times lower than in EU. Another evidence to the agriculture's deficiencies is the average cereal harvest, i.e. 20 quintal per hectare over EU's 55.

There are several factors behind such a discrepancy. Moldovan agriculture's inertia is largely due to ethno-psychological factors. In rural area family members is the main labour force for farms, whereas agricultural works are not mere occupation or source of income, but rather. Many peasants are so much committed that they spend much of their time in hard work. Large-scale exodus of rural population is yet another evidence to the excessive concentration of population in the restricted rural area.

Yet, despite those deficiencies one should exploit the opportunities provided by labour force migration if there is no room for it to be used at home. Collateral costs left aside - including psychological ones, such as the effect of families torn apart or children left home alone - to a certain extend labour force exodus is preferred to work at home, as the income is much higher. Noteworthy, money transferred by Moldovans working abroad in 2003 alone have reached 400 m USD.

Another factor speaking to the deficiencies of Moldovan agriculture is the country's tiny territory and relative homogenous landscape, which makes it rather difficult to spread the risk between various climate and geographic zones and makes the country particularly vulnerable to unfavourable climate conditions and natural disasters. Agricultural production has significantly dropped over the years and significantly eroded farmers' chances to make a living on working private land. On top of that, irrigation system was destroyed as was fertilisation one, which decreased genetic variety of the species, both in crops and husbandry. Given the lack of insurance in agriculture, Moldova boasts the highest dependence of harvest on climate. The situation gets even worse due to excessive fragmentation of agricultural plots. Under those circumstance Moldovan exports consist mainly of maze and sunflower, which as a rule are low competitive.

There are few and definitely not enough structures, private or public, that would monitor foreign agricultural markets and provide informational support to domestic farmers. Farmers still find it hard to get credits, which has decreased investments in agriculture and eroded chances of developing a profitable and efficient agricultural sector. There are no clear-cut and transparent rules for the operation of an agricultural market or Agricultural Exchange that makes it hard to get information. Conversely, it helps the state and certain specialised companies hold the monopoly in the field, or even worse, to resort to administrative levers in acquisition of agricultural products.

Incomplete privatisation of agricultural machinery and equipment has enabled "Joint Stock Companies" or "Production Associations", which are not that much different from the soviet kolhoz or sovhoz, to take them under control. The mere fact that the structure of farming hasn't evolved much towards more democratic forms of organisation brings to light deep contradictions between the desire to reform on the one hand, and technical and material possibilities on the other.

There are a number of opportunities, such as to tap into WB or EBRD's funds that have opened several quite cheap credit lines for projects in agriculture at several domestic commercial banks. Another opportunity, not fully exploited yet, is to mobilise local funds via Savings and Loans Associations. In addition, Moldova is known for its organic food, which is in big demand on EU markets. In general, prices on EU markets are much higher than in Moldova that leaves room for fat profit margins, and this only if Moldovan farmers manage to seize strategic niches on those markets.

Association to EU would open new opportunities to develop Moldovan agriculture and raise living standards in rural communities by exploiting European structural funds (such as FEOGA) that are financing projects on regional development. Even the disadvantage of might open new possibilities to modernise agriculture by easy access to the latest European developments in agriculture.

1000 and 100 days of the Government of V. Tarlev
Anatoli Gudim, 28 April 2004

Democracy and governing in Moldova e-journal, II year, no. 29, 28 April 2004

On April 19, 2001 Parliament has quickly - in a half an hour - approved the Programme of activity of the next, the 9th beginning from 1990, Government of the Republic of Moldova. Contrary to expectations of skeptics (despite multiple changes to the team made during the "game") it is this government that turned out to be a long-liver.

This is mainly due to unfailing mechanisms of the vertical line of power - President, Parliament and Government as an executive body. Private sector (circa 80% of GDP) - entrepreneurs that seem to have adapted to market conditions over the decade of reforms - also backed up the stability. Plus, the yearly country's financial support of 300-500 mil USD from Moldovan citizens working abroad.

How can one assess quality of the Government's activity? My opinion is that it can be done first of all based on three most important criteria:

- Law enforcement in the country;
- Political stability both internal and external;
- Macroeconomic stability in combination with providing for basic social needs of the population: work, education, healthcare, social aid for the poor.

As regards the first two criteria, according to sociological polls, 2/3 of the population evaluate the situation in the country as satisfactory that, understandably, political scientists and sociologists, let alone opposition parties, do not mainly confirm.

But the main slogan of the Government's activity programme was "revival of the economy - revival of the country". And this was supposed to be achieved through "strengthening the role of the state in providing for sustainability of socio-economic development". What resulted from the above-mentioned can be seen from the table comprising the key macroeconomic indicators.

Moldova: main macroeconomic indicators

	Government's term	Year	GDP % change, year on year	Consumer price inflation, annual average, %	Consolidated budget deficit, % of GDP	Exchange rate, annual average, MDL/USD	Direct foreign investment, USD per capita	External trade balance, USD mil	State internal debt, % of GDP	State external debt, USD mil
1	**M. Druc**: May 1990 - June 1991, 12 months	1991	-17,5	201,4	...	-	...	...	...	...
2	**V. Muravschi**: June 1991 - June 1992, 12 months	1992	-29,1	1209	...	-	...	...	...	...
3	**A. Sangheli**: June 1992 - April 1994, 21 months	1993 1994	-1,2 -31,2	1284 587	-9,0 -10,6	-	... 14	... -54	6,0 6,0	255,7 506
4	**A. Sangheli**: April 1994 - Feb. 1997, 33 months	1995 1996	-1,4 -5,9	30,2 23,5	-6,8 -7,6	4,49 4,59	34 40	-55 -252	7,8 9,5	659 766
5	**I. Ciubuc**: Feb. 1997 - May 1998, 14 months	1997	+1,6	11,8	-7,8	4,63	60	-348	11,7	1004

6	**I. Ciubuc**: May 1998 - March 1999, 9 months	1998	-6,5	7,7	-3,3	5,38	84	-383	17,0	1003
7	**I. Sturza**: March 1999 - Dec. 1999, 9 months	1999	-3,4	39,3	-3,1	10,52	93	-137	15,7	935
8	**D. Braghis**: Dec. 1999 - March 2001, 15 months	2000	+2,1	31,3	-1,6	12,38	35,8	-294	12,2	997
9	**V. Tarlev**: April 2001 - ...	2001 2002 2003	+6,1 +7,8 +6,3	10,0 4,4 15,7	+0,6 -0,5 +1,6	12,87 13,6 13,2	43,3 30,6 11,9	-311 -378 -613	12,6 12,7 10,7	930 971 1000,2

Inconsistency between indicators is evident. On the one hand, there certainly was a GDP growth (21.6% over three years) that began to show as far back as the pre-crisis 1997 (+1.6%) and recommenced in 2000 (+2.1%). The National Bank controlled the Moldovan lei's exchange rate, while the Ministry of Finance controlled the balance of incomes and expenditures. Average wages and pensions increased (in 2003, for instance, by 31% and 28% correspondingly). 53.7% of all expenditures of the consolidated budget went to social sphere.

On the other hand - acute lack of investments (a start for the future!), huge trade balance deficit, slow export growth, burden of external and internal debt. And… danger of an inflation outburst.

The list of what had to be changed or improved is well-known both to the population, Government and its advisers from IMF and WB. It includes: quality of economic growth (now, only 1/3 of the GDP growth is being formed in real sector); nature of relations between the state and entrepreneurship, situation of the competition and business climate; division of power between central and local authorities; creation of new workplaces as a counteraction to the mass migration; restoration of free movement of persons and goods with Transnistria; fight against corruption and criminality; targeting of social aid to the poor.

In order to solve all these difficult tasks the Government will have to rise to another, higher level of initiative and creative work. After all, the most part of positive results achieved over these three years was due, as the President V. Voronin stated, "to the administrative resource". But this resource, state intervention into the economy has its limits. The more so since we are trying to revive the country with the help of the state apparatus that has not been reformed yet.

It is not excluded that the Government will estimate in May its activity during 2001-2003, including advantages and defects, and will rebut the opinion of the last IMF mission that reforms in Moldova have slowed down and, in some spheres, have even reversed.

In the meantime, Government in a regular manner set through its decision #351 of April 2, 2004 "the top-priority tasks of activity of the executive power for 2004" and an action plan of 177 (!) clauses to boot. These actions include suggestions of ministries and departments, while priorities seem to have been formulated "at the top".
Attention now! "The following is to be considered as the top-priority tasks of activity of the executive power for 2004:

- Development of human resources through constant formation of a modern system of education, healthcare, social guarantees, innovations and research and development;
- European integration and economic modernization of the country;
- Liberalization of economic activity, stimulation of investments, provision of transparency and stability of the legislation;
- Territorial reintegration of the country" (Monitorul Oficial al Republicii Moldova, #56-60, April 9, 2004, p. 62).

And all these lofty and general formulations are priorities for the final dash of the current Government, aren't they? What have the previous three years been spent for then? After all, it has been April 19, 2001, when each of these general tasks was set before the Government. And where is the "fighting poverty" idea from the most important, as the Government used to say, PRSP Strategy for 2004-2006?

But this decision is still useful: the Government gave the country a telling argument in favor of the pressing necessity to reform the state apparatus.